VZCZCXRO0378
PP RUEHAG RUEHDF RUEHIK RUEHLZ RUEHROV
DE RUEHNC #0621/01 2131258
ZNR UUUUU ZZH
P 311258Z JUL 08
FM AMEMBASSY NICOSIA
TO RUEHC/SECSTATE WASHDC PRIORITY 9022
INFO RUCNMEM/EU MEMBER STATES COLLECTIVE PRIORITY
RUEHAK/AMEMBASSY ANKARA PRIORITY 5249
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
RUEHBS/USEU BRUSSELS PRIORITY

UNCLAS SECTION 01 OF 02 NICOSIA 000621

SENSITIVE
SIPDIS

E.O. 12958: N/A
TAGS: ECON EFIN CY
SUBJECT: THE PROBLEMS OF ECONOMIC CONVERGENCE IN A REUNITED CYPRUS

¶1. (SBU) Summary. Thirty-four years of separation have created two distinct economies on Cyprus. The ROC is fully integrated into the global trading system and the EU, and enjoys a relatively high level of human capital. The north, primarily because of the policies (both G/C and T/C) that isolated it, have a substantial number of mid-level civil servants and office workers without the skill set necessary to compete in a fully competitive European economy. The same can be said for many T/C businesses. With reunification likely to end Turkish government financial support, the government of the north Cyprus entity will need to mobilize funds from the south and internationally to fund an extensive retraining program during a transition period leading to full economic integration. End Summary.

Reunification: Rising Tide Will Lift Some Boats; Sink Others

¶2. (SBU) There is little doubt that reunification would be an economic boon to the island. More tourists would visit the north, more trade would be conducted with Turkey, land prices in the north would appreciate to approach those in the south (i.e., perhaps 40 percent for pre-1974 Turkish-titled property, 70 percent for pre-1974 Greek-titled property) and consumer prices in the north would decline as competition increased. The south would benefit especially from the reconstruction of Varosha, the ghost-city that prior to 1974 was the tourist playground of the island. In 2003, the ROC Planning Board estimated that reconstruction of Varosha would cost US$2.5 billion (about 17 percent of GDP.) Note: We believe it would cost considerably more to raze and rebuild a city occupied by about 60,000 people in 1974. End Note. The biggest risk to the island's economy as a whole would be inflation from all the new construction activity. The question is whether a less-skilled T/C workforce and a largely unsophisticated and uncompetitive T/C business community would have the wherewithal to take advantage of the increased wealth, or if an inordinate percentage would accrue to the G/C community.

A Tale of Two Economies

¶3. (U) The economy of the Republic of Cyprus is a post-industrial model of an open, internationally integrated, services-based system supported by large tourism and property-development sectors. A long-term government effort to make Cyprus attractive as an off-shore base within the EU (10 percent income tax rates, numerous bilateral tax and investment treaties, relatively high technical skill levels - especially in the financial services sector - and widespread use of English) have provided a sustainable base for the ROC's continued economic viability. A measure of this success is a forecast 3.7 percent GDP growth rate in 2008 in the face of the current global economic uncertainty (Q1 2008 GDP grew at an annualized 4 percent.)

¶4. (U) The economy of northern Cyprus is a largely artificial

construct based on an extremely large public sector supported by generous subsidies from Turkey and cheap labor imported from eastern Anatolia. The business community has little interaction internationally and, despite the relatively high cost of inputs and low productivity, lives off the high margins that result from limited domestic competition and government contracts. Exports in 2007 totaled only US$81 million, mostly unprocessed fruit and vegetables, building materials, and a few simple manufactured products such as aluminum window frames. The mass tourism sector (about 80 percent of all visitors are Turkish) is increasingly controlled by Turkish equity, and the housing boom that ignited the economy 2003-2006 has reversed course, with thousands of empty homes that developers can't sell. Tourism, a major contributor to the north's economy, is especially weak as evidenced by a mere 28 percent occupancy rate in the north's hotels in June. As a result, the GDP shrank about 2.1 percent in 2007 and anecdotally (since quarterly macro economic statistics are not compiled) has continued to decline.

¶5. (U) North Cyprus' GDP in 2007 was US$3.3 billion, US$12,021 per capita, assuming a population of 300,000. The per capita number, however, is inflated by the official inflows from Turkey (around US$400 million/year). One local economist reckons that, if all Turkish aid, loans, military spending, and spending by Turkish companies (using Turkish government money) were subtracted out, a more accurate GDP per capita figure would be around US$7000. The corresponding GDP figures for the ROC in 2007 were US$21.3 billion; US$27,078 per capita; 93 percent of the EU's average.

Things Are Tough in the Real World

¶6. (SBU) Various studies over the years have all concluded that a reunified Cyprus would generate additional economic growth across the island. One study undertaken by local economists (on both sides) this spring concluded that, over the medium-term, GDP per capita would increase Euros 5500 largely from increased Cyprus-Turkey trade and investment. The concern of many T/C businessmen is that they may not directly benefit from this increased trade and, in fact, may suffer from the increased competition from G/C business. A major accounting firm in the north noted that his association with Price Waterhouse in Turkey would come to an end with a reunified Cyprus because Price Waterhouse in the ROC would become the sole PWC presence on the island. He believed that PWC Cyprus would only work with him if he agreed to sell his company to the G/C partners. There is considerable concern that, notwithstanding long relationships with Turkish suppliers, the Turks will prefer to do business with the larger G/C firms and their potentially more lucrative market. Furthermore, individual T/Cs are not typically as adept at English language, computer usage, or finance as their G/C brethren. This makes them less competitive in a single market workplace. As civil servants are made redundant from the current padded "TRNC" rolls, and businesses in the north consolidate or disappear under pressure from southern competitors, there will be a significant number of T/Cs who will find that they do not have the skills to land a position similar to the ones they enjoyed under "isolation." The result could be considerable social pressure as G/Cs in general (along with better-educated or skilled T/Cs) enjoy the benefits of the general economic expansion, but a significant minority of middle-class T/Cs find themselves moving down the social ladder.

¶7. (SBU) Under the Annan Plan, the T/Cs were provided a three-year period of protection from their larger, better capitalized, and more aggressive G/C competitors. Presumably, the current T/C negotiating demand for permanent derogations to the acquis communautaire requirements for free movement of capital and labor will be dropped in favor of a limited period of protection during which T/C business will

restructure and prepare for life outside isolation. To the extent that continued protection prevents or delays T/C business from proceeding with the necessary adjustments, it will cause only further pain in the adjustment process. At least one economist argues that instead of negative prohibitions on G/C business to protect T/C economic interests, an "affirmative action" policy be utilized allotting some share of public sector contracts and procurements throughout the united Cyprus to be set aside for T/C contractors or sub-contractors. This might also speed the creation of joint ventures between the communities.

¶8. (SBU) Comment: The creation of a single federal Cyprus will probably require the Turkish portion of the Cypriot federation to find replacement income for most, if not all, of the financial support previously provided by the Turkish government. Some T/C economists suggest large transfers from the G/C entity, largely replicating West Germany's approach in integrating East Germany. We have doubts that this would be politically possible for a G/C leader. In any case, the cost of preparing T/C business and workers for reunification cannot be managed by the north alone, but without a focused, comprehensive (and therefore expensive) effort on upgrading language and technical skills during a period of protected transition, the newly-united nation runs the risk of social instability based on apparent differences in job opportunities and income levels between ethnic groups. The irony is that the dearth of skills among T/Cs is largely the result of the longstanding ROC policy of economically and politically isolating the north, and the somewhat self-isolating T/C response. Going forward, the consequences of the isolation policy could rebound against the reunified entity the policy was designed to bring about.

SCHLICHER